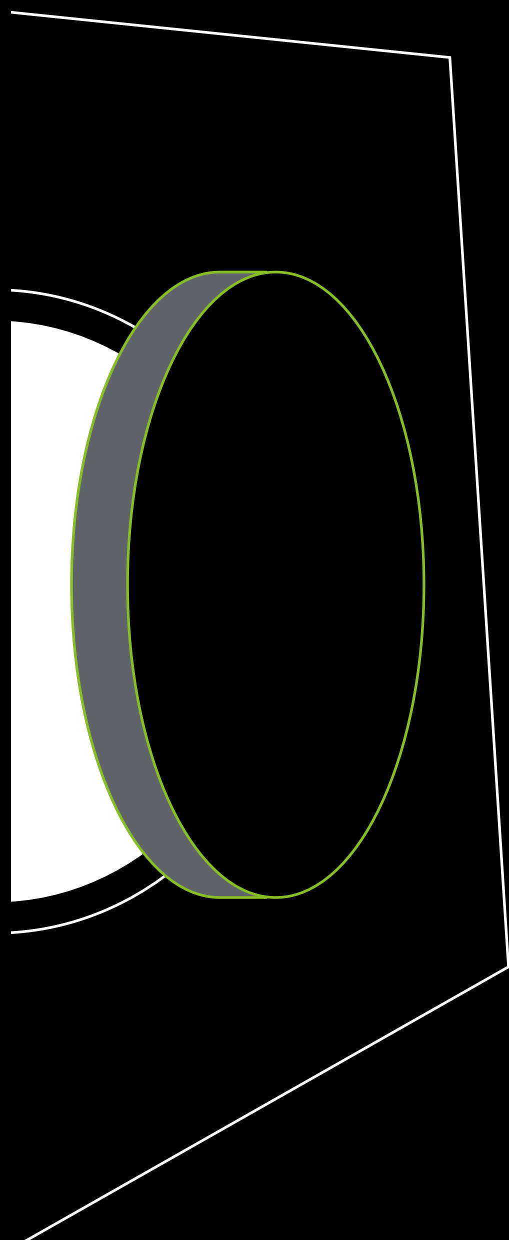
Tax implications of fund investing

The idea of pooling resources and spreading risk using investment funds (or funds) is not a new idea. It has been used for a long time and the complexities associated with funds continue to grow. Similar to traditional investments, such as a direct investment in a marketable security, the economic cycles from the Great Depression, to the dot-com era, to the global financial crisis of 2008/2009 impact the success of these vehicles. However, many view access to investment through funds with qualified investment professionals as a valuable diversification tool in the management of their investment portfolio that helps to mitigate the impact of economic cycles.



Tax implications of fund investing

Introduction

As a taxpayer and an investor, you should be informed about significant tax and nontax attributes of fund investments and manage your portfolio in a manner consistent with your understanding of those attributes. Taking time to understand the tax consequences of investing in a specific fund will help you produce a more tax efficient result overall. Thoughtful planning requires an understanding of a fund advisor's investment strategy and how that may impact your personal tax situation, whether the investment fails or succeeds. This includes analyzing the tax treatment upon contribution of capital, evaluating the impact while you hold, and assessing the consequences upon sale or other disposition of the fund investment.

For example, before acquiring new fund investments, it is important for you to understand the character of the income that may be generated by the fund, as well as when you may recognize such income. Will the income or gains be subject to the highest ordinary income tax rates or will the income allocated to you be subject to preferential tax rates? Furthermore, you should discuss with your advisor whether you will receive a tax benefit from the expenses and losses that may be allocated to you. The deductibility of some fund level expenses may be limited by the itemized deduction phase-out provisions or added back under the alternative minimum tax (AMT) regime. Other expenses from a fund may directly offset income from fund or non-fund activities. Furthermore, losses may be disallowed in the current year if you are subject to the passive activity loss limitation rules.

Failing to understand the character of income and expenses that a fund will pass through to you can lead to unwelcome surprises when you receive the final tax information each year. In addition, fund investments may cause significant state implications and create foreign reporting requirements. Having a clear understanding of a fund's strategy and the tax implications of investing in that fund allows you to make a more informed investment decision. To do so, let's discuss the types of funds that exist, the character traits of each fund, and the tax consequences of investing in each type of fund.

As a taxpayer and an investor, you should be informed about significant tax and nontax attributes of fund investments and manage your portfolio in a manner consistent with your understanding of those attributes.

What is an investment fund?

The popularity of funds continues to grow, and as of December 31, 2015, it was estimated that $3.65 trillion[1] was invested globally into private equity and $2.8 trillion[2] was invested into hedge funds.

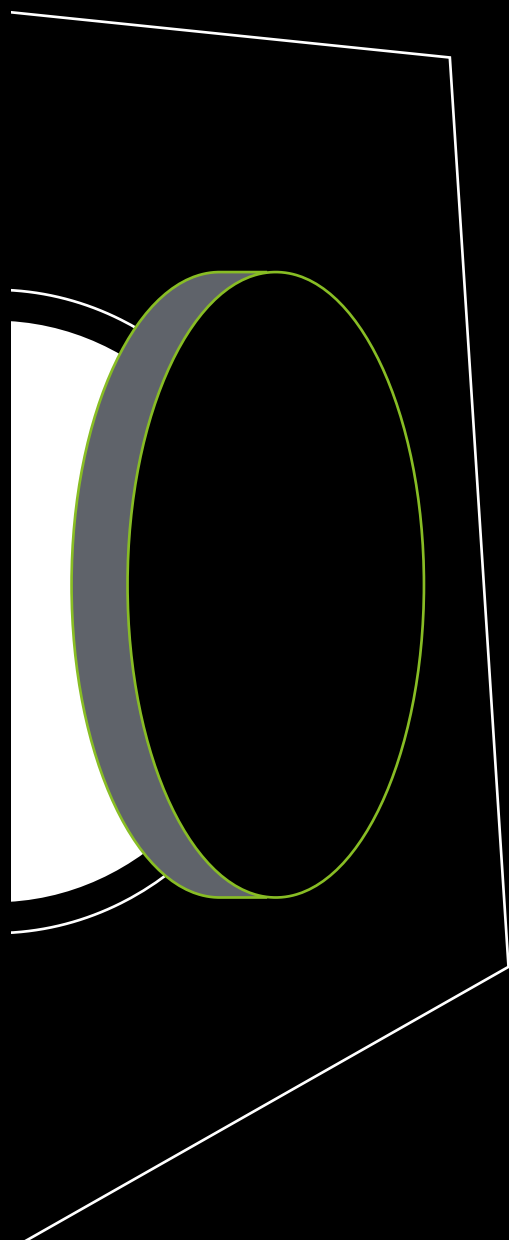
Investment funds are types of investment companies that are typically organized as partnerships. An investment company invests the money it receives from investors on a collective basis, and each investor generally shares in the profits and losses in proportion to the investor's interest in the investment company. The performance of the investment company will be based on (but it will not be identical to) the performance of the securities and other assets that the investment company owns.

The focus of this summary is on investment companies organized as partnerships, which are typically described as investment funds. These investment funds are typically structured as partnerships for tax purposes, either as limited partnerships (LPs) or limited liability companies (LLCs). The partnership tax structure is typically used by investment funds, rather than a corporate investment vehicle, to allow for the investment fund's income to be taxed at the investor level and provide for flow-through treatment of income, expense, gains, and losses. Although mutual funds are a type of investment company, they are typically organized as corporations and will not be addressed in this summary.

Investors in investment funds include pension funds, sovereign wealth funds, endowment plans, family offices, high-net worth individuals, foundations, and insurance companies. Funds may be referred to as alternative investments and commonly include marketable security funds, hedge funds, private equity funds, and real estate funds. The popularity of funds continues to grow, and as of December 31, 2015, it was estimated that $3.65 trillion[1] was invested globally into private equity and $2.8 trillion[2] was invested into hedge funds. A more detailed discussion on the different types of funds available for investment follows.

[1] By Deloitte estimate, based on prorating the $3.5T figure from Preqin data as of June 2015, forward to December 2015. © 2016 Preqin Ltd. www.preqin.com. Note: Venture capital data are excluded from this number.

[2] BarclayHedge Ltd. Data as of December 2015, www.barclayhedge.com.



Types of investment funds and income tax characteristics

The character of income and loss allocable to investors directly impacts after-tax returns on investments and can vary significantly between types of funds.

Marketable security funds

Marketable security funds (MSF) are investment funds that typically trade in stocks, bonds, and other marketable securities on the behalf of their partners. The purpose of these investments is to provide portfolio diversification by pooling capital from investors and investing in a broad base of investments. Many MSFs have an investment strategy targeted to a specific asset class such as small cap, large cap, international, or emerging markets, while other funds may look to invest more holistically across multiple strategies. Leverage is typically not utilized by MSFs.

Investments in MSFs are relatively liquid allowing investors to contribute cash or make withdrawals on a frequent basis such as monthly. Depending on whether a partner's investment in the MSF is in an appreciated or depreciated state, as compared to the partner's tax basis in the MSF, many MSFs will allocate additional gains or losses to partners at the time they redeem some or all of their interest in a MSF in an effort to eliminate or limit this disparity.

Character of income considerations—MSF

The investment strategy of a MSF directly impacts the character of the income and loss generated by the fund. The character of income and loss allocable to investors directly impacts after-tax returns on investments and can vary significantly between types of funds. As a result, having a good expectation of this impact is important when making investments. MSFs typically invest in marketable securities and generate dividends, interest, tax-exempt interest, capital gains, foreign taxes, and expenses. Preferential income tax rates are available for qualified dividends and long-term capital gains. If a MSF is considered in the trade or business of trading securities (discussed further on page 57), the expenses can be tax effective and offset an investor's ordinary income from other sources. Additional information is available in the Individual Income Tax Planning section of the 2017 Essential Tax and Wealth Planning Guide regarding income tax rates, types of income, and planning considerations.

Hedge funds

Hedge funds (HF) are investment funds that can use one or more alternative investment strategies, including hedging against market downturns, investing in asset classes such as currencies or distressed securities, and utilizing return-enhancing tools such as leverage, derivatives, and arbitrage.[3] Many, but not all, HF strategies tend to hedge against downturns in the markets being traded. HFs are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.).[4] There is typically broad discretion over investment objectives, asset classes, and investment vehicles.

Use of leverage

HFs typically utilize leverage to execute their investment strategy. Many HFs will buy securities on margin to increase the amount of exposure to a strategy. For example, if a HF received capital contributions from its investors of $10,000,000, by using leverage, it may be able to borrow $5,000,000 (buying on margin) so that it is able to invest $15,000,000. To the extent the HF can borrow assets to purchase more securities,

[3] Per http://www.hedgefundassoc.org/about_hedge_funds

[4] Per http://www.hedgefundassoc.org/about_hedge_funds

Types of investment funds and income tax characteristics

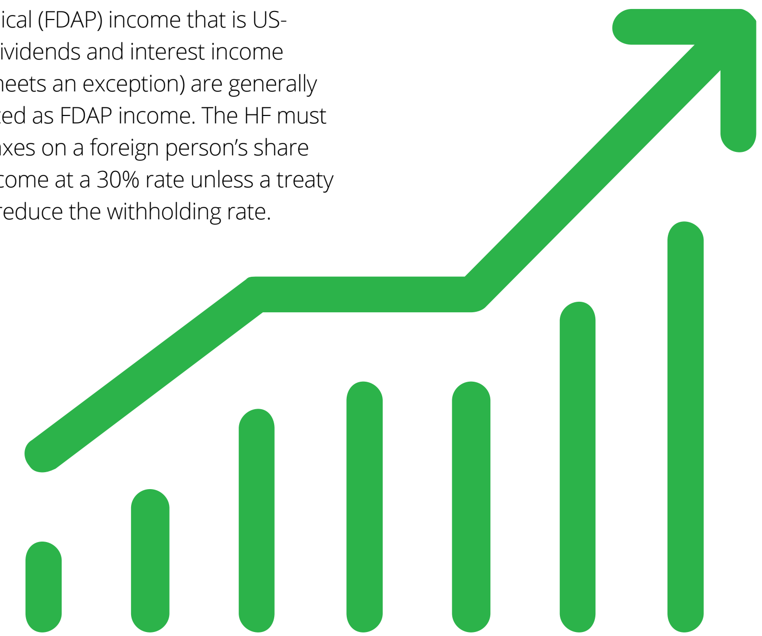
there is greater opportunity for income and appreciation on those securities. It can also create additional risk on the downside to the extent the assets depreciate in value. Similar to buying on margin, lines of credits are another type of leverage that HFs utilize. HFs may also purchase financial instruments such as options, warrants, and convertible securities to increase leverage and potential upside.

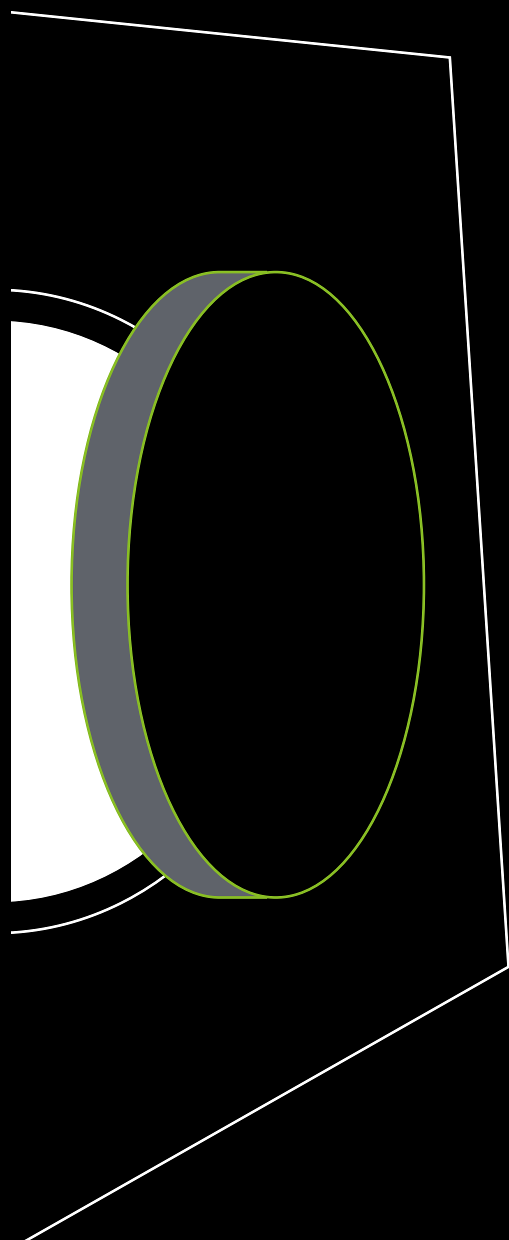
Offshore blocker corporations

While most HFs are structured as LPs or LLCs, offshore blocker corporations are frequently offered as an alternative investment vehicle for US tax-exempt investors and foreign investors. While a partnership investment may be more tax efficient than an investment in a foreign corporation, a US tax-exempt investor and a foreign investor typically prefer to invest through the blocker corporation to limit the US income tax exposure and filing obligations related to investing in a HF. Additionally, tax-exempt investors and pension funds generally prefer to invest through the offshore blocker corporation to "block" the flow of unrelated business taxable income that would otherwise be allocated to them (see discussion on page 60). Generally, a non-US person who is allocated income from a HF that trades in stocks or securities in the United States is not treated as engaged in a US trade or business. This safe harbor exception applies to trading in stocks, securities, and options to buy or sell stocks and securities, including margin transactions and short sales. If the HF satisfies this safe harbor exception, it will not be treated as engaged in a US trade or business. However, if the HF does not satisfy the safe harbor exception, the fund would generate effectively connected income (ECI), and the fund would be required to withhold US taxes on the foreign investor's share of ECI.

Even if the HF is not engaged in a US trade or business, it is still required to withhold taxes on fixed, determinable, annual, and periodical (FDAP) income that is US-sourced. Dividends and interest income (unless it meets an exception) are generally characterized as FDAP income. The HF must withhold taxes on a foreign person's share of FDAP income at a 30% rate unless a treaty applies to reduce the withholding rate.

To the extent a foreign person is allocated either ECI or FDAP income, the foreign person has a US tax return filing obligation. Therefore, foreign investors would prefer to invest through a blocker corporation to avoid being allocated a share of the HF's US income, which would obligate them to file a US tax return. While a US C corporation would generally be required to pay tax at the highest US tax rate, many





Types of investment funds and income tax characteristics

foreign investors would prefer to block the income through the corporate vehicle and pay the higher tax on the income so that they themselves do not have a US tax filing obligation. Therefore, foreign individuals and foreign trusts should understand the character of the income that will be generated by the HF so that they can identify the investment vehicle that would best satisfy their needs.

HFs are traditionally less liquid than MSFs, but investors are typically able to acquire or redeem interests in HFs on a quarterly basis at a minimum. Similar to a MSF, partners who partially or fully redeem interests in an HF should understand if the HF will allocate additional gains or losses to eliminate the disparity between their economic capital account and their tax basis in the HF.

> Foreign individuals and foreign trusts should understand the character of the income that will be generated by the HF so that they can identify the investment vehicle that would best satisfy their needs.

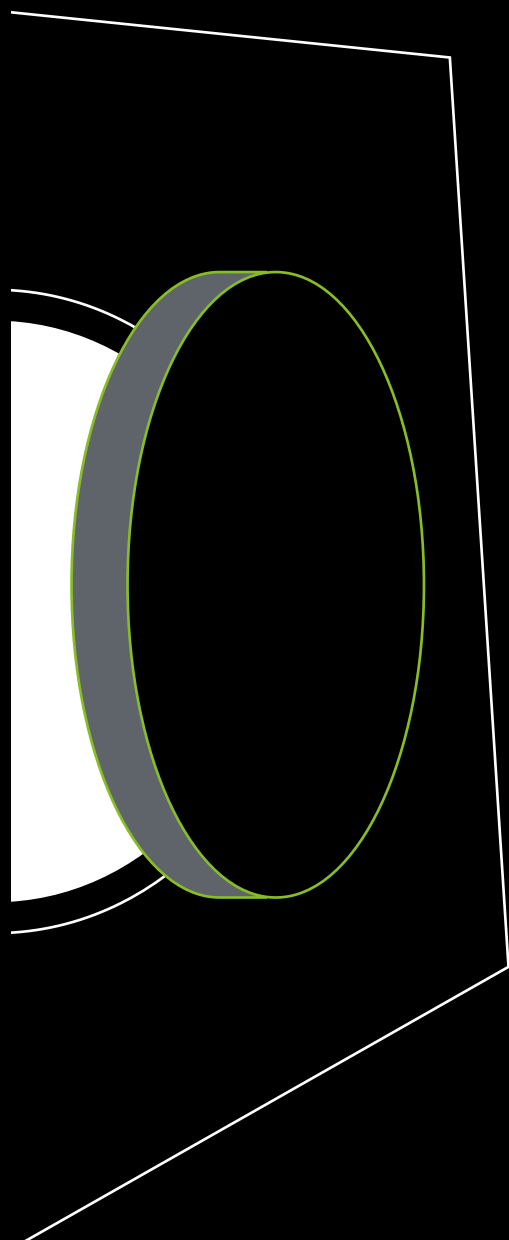
Character of income considerations—HFs

The income generated by an HF is often similar to the income generated by an MSF. In addition, HFs may also generate the following types of income:

- The HFs that trade in regulated futures contracts and/or foreign currency contracts will recognize income/loss taxed under the provisions of IRC §1256. To the extent IRC §1256 applies, the income/loss from these contracts will be recharacterized as follows: 60% classified as long-term capital gains/losses and 40% classified as short-term capital gains/losses.
- For HFs that have made an IRC §475 mark-to-market election, investments are marked up or down to their fair market value at the end of the year and ordinary income or loss is recognized to the extent of the mark. Many HFs with a trading strategy seeking to profit from swings in the daily market movements make an IRC §475 election. Losses are ordinary in nature and not subject to capital loss limitations. Also, because short-term capital gains and ordinary income are taxed at the same tax rate, there is no disadvantage because income is taxable at ordinary income rates.
- HFs typically invest in a variety of financial instruments. The instruments utilized by HFs include options, warrants, convertible securities, and joint venture agreements. The taxation of these instruments is complex and can vary by the type of investment.

Private equity and venture capital funds

Private equity funds (PEF) are investment funds that pool capital for investment in privately-owned businesses at different stages of development. PEFs invest in privately-owned C corporations and partnerships with the ultimate objective of long-term capital appreciation. The PEF will enhance the company's value by working with the management team to increase revenue streams, reduce expenses, improve cash flow, and increase margins. The exit strategy for the PEF may include selling the investment to a strategic buyer, another PEF, or possibly taking the company public. The lifecycle of a PEF will be stated in the offering documents but is typically 7-13 years, depending on its investment strategy.



Types of investment funds and income tax characteristics

The investment period of the PEF is typically closed to new investors 6-12 months after the initial closing. To the extent that investors acquire an interest in the fund after the first fund closing, they are often required to pay interest to the fund and the fund allocates this interest income to the investors who invested in the first closing. The general partner (GP) will require capital contributions to be made to the fund over a 3-5 year commitment period. The PEF calls capital commitments in stages as it identifies investment opportunities or as needed to fund management fees and other expenses. Capital contributions are made pro rata by all partners in proportion to their capital commitments, with the limited partners committing most of the capital and the GP contributing a small portion of the capital.

Investments in PEFs are typically illiquid, as capital is locked-up for many years, with infrequent distributions until there is a liquidity event. Investors typically do not have an ability to withdraw their capital. The PEF's profits and losses are allocated to the capital accounts of the partners as agreed upon in the partnership agreement. The PEF's profits are typically distributed to all partners based on their respective capital contributions, with a preferred return allocable to the limited partners over the life of the fund primarily for the use of their capital. In most instances, the GP or a separate management company is paid an annual management fee. To the extent the PEF earns an aggregate return on its investment that exceeds the preferred return, management fees, and partnership expenses, the GP will be allocated a portion of the excess profit, referred to as the carried interest.

Lifecycle of a Private Equity Fund

Marketing period	Investment period	Holding period	Exit period
Raise capital	Call capital	Manage portfolio	Dispose of investments
Set up fund entity structure	Find and make investments	Collect management fees	Return capital and wrap up fund
Offering and closings	Allocate carry		Collect management fees
	Collect management fees		Collect carry, if profitable

Some PEFs have started to use debt or lines of credit to help fund investments in portfolio companies for a period of time between when an opportunity is identified and when the capital can be called from investors. If implementing such a strategy, the PEF is generally able to increase the internal rate of returns to its investors, but this approach can create tax ramifications, specifically for tax-exempt investors, creating unrelated business taxable income (UBTI). See page 60 for additional information on UBTI.

Venture Capital Funds

A venture capital (VCF) is a type of PEF that typically focuses on providing equity and financing to start-up emerging businesses with a focus on providing its investors above-average returns. VCFs can be attractive to investors versus traditional PEFs because they typically invest in businesses that are less developed. If these less-developed businesses become successful, they may provide for higher growth opportunities. On the other hand, there is more risk on the downside because many of the less-developed businesses may ultimately not be successful. Another difference between VCFs and PEFs is that investments in VCFs are typically equity whereas investments in PEFs can be both equity and debt.

Types of investment funds and income tax characteristics

Character of income considerations—PEF and VCF
Income generated from PEFs and VCFs is typically dependent on the type of investment. For many PEFs that are investing in businesses organized as partnerships, there will typically be operating income or losses flowing through to the investor which are subject to ordinary tax rates. For PEFs investing in businesses organized as corporations, any operating income from that business will not flow through to the PEF nor to the PEF's investors.

Depending on the type of investments made by PEFs and VCFs, some funds may include alternative investment vehicles (AIV) in their fund structure. An AIV is simply a fund partnership typically created to allow tax sensitive investors to invest, side by side, with the main fund, for example, in a flow-through portfolio company. The AIV structure will typically have a blocker corporation as a limited partner in the AIV, through which tax-sensitive limited partners invest.

When a PEF or VCF disposes of a portfolio company structured as a corporation, the gain/loss is treated as short-or-long-term capital gain, depending on the time that the fund held the investment. When a PEF or VCF disposes of a portfolio company structured as a partnership, the ordinary income portion will be similar to the amount that would be recognized if the underlying operating business conducted by the portfolio company was sold. Such a disposition results in gain taxed as ordinary income (to the extent of ordinary deductions required to be recaptured or to the extent of gain attributable to assets the sale of which would be treated as ordinary income (e.g., inventory), with the remainder of the gain (if any) being taxed at the long-term capital gain rate. In some cases, if the underlying investments are in the energy industry, there may be unique tax treatment of certain items for those types of investments. Lastly, see the additional discussion on page 59 regarding qualified small business stock, which may apply for certain types of PEF or VCF investments.

As a PEF or VCF recognizes items of income, gain, loss, deduction, and credit, such items are allocated among its partners based upon the economic terms of the LP agreement. Such allocations take into consideration each partner's rights under the economic terms set forth in the fund's LP agreement. Generally speaking, the allocations will reflect each limited partner's right to return of capital, preferred return, and an allocable share of upside gain on the disposition of an investment.

In addition, the allocations will reflect the GP's right to return of capital, carried interest, and upside gain on disposition of an investment. The character of any item of income, gain, loss, deduction, or credit allocated to the GP under the carried interest provisions of the LP agreement for a PEF or VCF is determined by the LP and retains its character when reported by the GP. Although a GP's carried interest in many instances is not determined until late in a calendar year or after the calendar year end, the timing of when the items are included in the GP's carried interest coincides with when the items are recognized by the PEF or VCF. For example, if the fund recognizes long-term capital gain on the sale of corporate stock in January, and such gain results in an allocation of gain to the GP under the carried interest provisions of the LP agreement, then such income is treated as allocated to the GP in the first quarter and should be taken into account for quarterly estimated tax purposes accordingly.

Types of investment funds and income tax characteristics

Publicly traded partnerships (PTP)

A publicly traded partnership (PTP) is a partnership that is either traded on an established securities market or readily traded on a secondary market or the substantial equivalent of a secondary market. Partnerships that are publicly traded are classified as corporations for US federal income tax purposes unless at least 90% of the partnership's gross income is from sources commonly considered to be passive or from certain types of businesses historically conducted in partnership form (qualifying income). PTPs that are structured as pass through entities pay no corporate level taxes and owners of a PTP are called unitholders.

In order to qualify as a PTP, the fund must satisfy specific income requirements to take advantage of these tax efficiencies. Taxes are not paid at the fund level but are paid by the partners at the partner's individual rate on amounts reported to them by the fund on Schedule K-1. Periodic distributions received from PTP investments are generally not taxed and treated as a return of capital.

Note, the term master limited partnership (MLP) is used interchangeably to refer to a PTP, generally in the natural resource industries. An MLP often refers to a tiered limited partnership structure in which operations are conducted by lower-tier partnerships or other subsidiaries (often disregarded for tax purposes) held by the publicly traded MLP.

Character of income considerations—publicly traded partnerships

PTPs are statutorily required to be separately stated (see page 58 for an additional discussion on separately stated activities). This requirement can be time consuming, which creates additional administrative burden in tax return preparation. In addition, PTPs typically have activities in multiple state jurisdictions. Therefore, it is important to understand any additional state filing obligations that may be created upon making an investment directly in a PTP or indirectly through the use of a partnership.

Typically, PTPs can be efficient from a tax perspective because PTPs frequently produce losses (although one needs to consider the impact of the passive activity rules discussed more on page 57) due to accelerated depreciation. Once PTPs are sold, a portion of the gain/loss on disposition is taxable as ordinary income/loss and a portion is taxable as capital gain/loss. Also, PTPs commonly make quarterly distributions of operating cash flow, which are typically tax-free as long as there is basis in the investment.

It is important to understand any additional state filing obligations that may be created upon making an investment directly in a PTP or indirectly through the use of a partnership.

Types of investment funds and income tax characteristics

Real estate funds

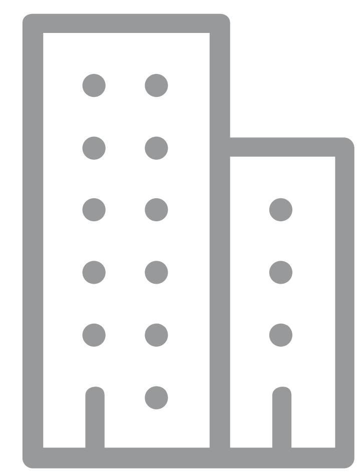
Real estate funds (REF) are investment funds that pool capital for investment in real estate (including direct investment in property, other real estate partnerships, real estate investment trusts (REITs) or real estate operating companies). Traditionally, REFs include US taxable (usually individuals), US tax-exempt, foreign taxable (generally individuals or corporations), and foreign tax-exempt investors. Similar to other funds operating as partnerships, income and loss flows through to the partners resulting in one level of tax at the partner level. Investors in REFs may also be subject to the Foreign Investment in Real Property Tax Act (FIRPTA) rules.[5] REFs often operate similarly to private equity and venture capital funds from a capital commitment and liquidity perceptive.

Shares of REITs are often traded on public exchanges and encourage widespread passive investment in real estate by investors interested in liquidity. A REIT is a special entity for US federal income tax purposes that meets certain technical requirements and elects REIT status. The key difference between a regular US corporation and a REIT is that a REIT is allowed a tax deduction for dividends paid to its shareholders. In order to qualify for this special treatment, a REIT must, among many other requirements, distribute at least 90% of its taxable income (exclusive of capital gains) to its shareholders. As a result, REITs rarely pay federal income tax, but REIT shareholders will pay tax on amounts distributed as dividends, resulting in one level of income tax.

In many instances, REITs may be formed to facilitate investments by REFs. These REITs are frequently referred to as private or "baby" REITs. These REITs are frequently formed to reduce an investor's exposure to state income taxes and attract foreign and tax-exempt investors.

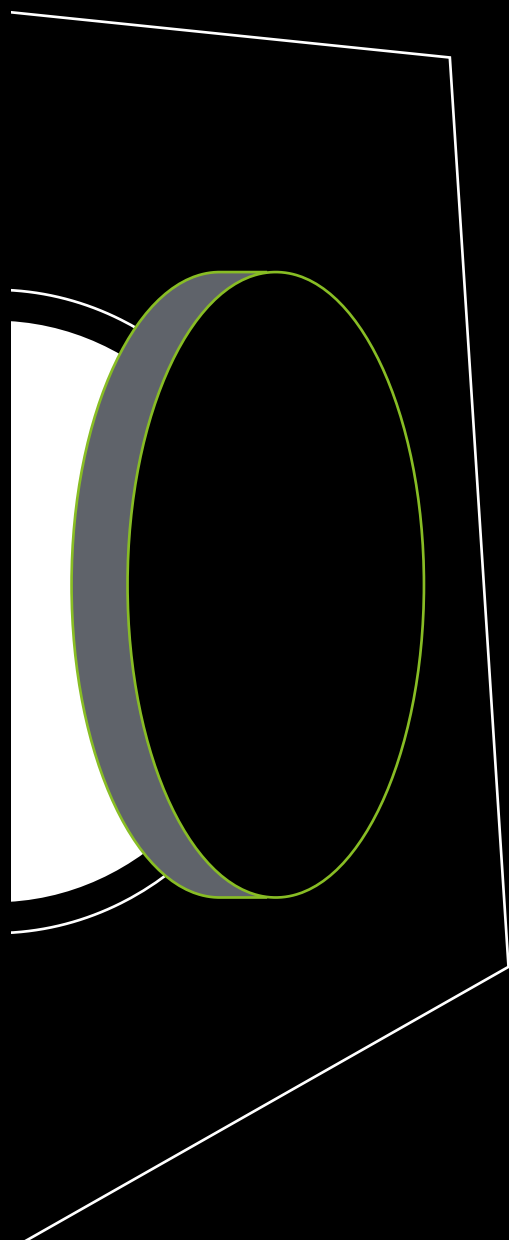
Character of income considerations—real estate funds
Most REF investments generate taxable income or loss from the rental of properties to 3rd parties, and in those cases, rental real estate income is taxable as ordinary income. In many instances, real estate may operate at a loss as a result of depreciation and interest deductions. The deductibility of these losses may be deferred as a result of the application of the passive activity rules (discussed further in the passive versus non-passive section on page 57). Note, the passive activity rules apply to individuals and other entities, such as trusts, that are not considered real estate professionals that materially participate in the rental activity.[6]

Generally, gain or loss upon the sale of investment real property is taxed as IRC Section 1231 gain or loss. Gain is typically taxed at capital gain rates, except to the extent the gain is considered depreciation recapture. Loss is generally treated as ordinary loss. When REF investments are sold, typically any gain is going to be taxed at a 25% rate (to the extent ordinary deductions were taken for tax depreciation) with the remainder of the income being taxed at the long-term capital gain preferential rate of 20%.



[5] FIRPTA requires foreign individual, trust, and corporate investors to treat gain or loss on the disposition of a US real property interest ("USRPI") as if such gain or loss is ECI.

[6] Real estate professionals must spend the majority of their time in the real estate property business and have a minimum of 750 hours a year.



Types of investment funds and income tax characteristics

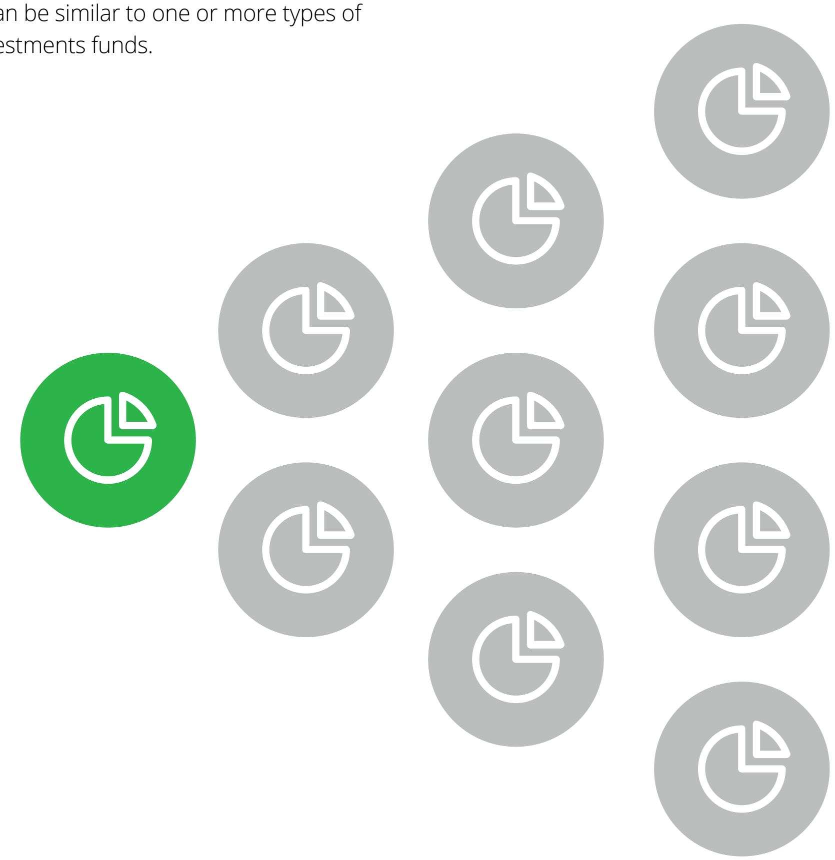
Fund of funds

The term fund of funds (FOF) refers to an investment fund with an investment strategy designed to hold a series of underlying fund investments versus directly owning stocks, bonds, operating entities, and other assets. FOFs are typically structured as LPs or LLCs.

FOF are typically organized by the type of underlying investment funds; for example, a hedge fund FOF, private equity FOF, real estate FOF, or publicly traded partnership FOF. Alternatively, it is possible for a FOF to be setup with investments across multiple types of investments, though this is less common. One benefit many find with a FOF structure is that FOFs provide access to funds investors may not be able to invest in directly. For example, many funds have contribution minimums for investors. If an investor can't meet the contribution minimum, the investor may be able to gain exposure to the fund by commingling its capital with others in a FOF structure to be able to meet the contribution minimum and obtain access. Consideration should be given to the additional layer of management and performance fees at the FOF level, in addition to the fees that are being charged by the underlying investment funds.

Character of income considerations—fund of funds

The tax attributes of FOF are similar to the aforementioned investment funds. Depending on the investments of FOFs, it can be similar to one or more types of investments funds.



Tax implications of fund investing

Investment fund attributes

Key tax attributes of investment funds include 1) the characteristics of the fund itself and 2) the character of income, expense, gain, loss, and credits generated by the fund (or allocable to the fund in a FOF setting) and how these amounts impact the investor's tax liability. Taxpayers may invest in a wide variety of funds but may not be aware of how the investment strategy (e.g., holding securities short or long, trading through derivatives, buying dividend paying stocks, purchasing operating company investments, etc.) could impact the character of the income, losses, and deductions generated by the investment.

The below chart and discussion can assist you in understanding the attributes of funds and the character of income and expenses coming from the funds.

Investment fund attributes
Entity characteristics, income/(expense) characteristics, and other considerations

	Fund of funds*				
	Marketable security partnership	**Hedge fund partnership**	**Private equity/ Venture Capital partnership**	**Publicly traded partnerships**	**Real estate partnerships**
Entity characteristics					
Classified as a business trading securities	Sometimes	Sometimes	No	No	No
Classified as an operating business	No	No	Sometimes	Sometimes	Sometimes
Classified as an investor partnership	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
State sourced income generated	No	Sometimes	Sometimes	Frequently	Yes
PTP separately stated activities	No	Sometimes	Sometimes	Yes	No
Non-PTP separately stated activities	No	No	Yes	Sometimes	Yes
Qualified small business stock	No	Rarely	Sometimes	Rarely	Rarely
Operating business unrelated business taxable income	No	Sometimes	Yes	Yes	Yes
Debt financed unrelated business taxable income	No	Frequently	Yes	Sometimes	Yes
Foreign reporting requirements	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
Capital commitments	No	No	Yes	No	Yes
Usage of leverage	No	Frequently	Sometimes	Sometimes	Sometimes

* Fund of funds can include multiple investment funds in one strategy (hedge funds for example) or can be across investment fund strategies (hedge fund, private equity, publicly traded partnerships, etc.)

Tax implications of fund investing

Investment fund attributes

Investment fund attributes
Entity characteristics, income/(expense) characteristics, and other considerations

	Fund of funds				
	Marketable security partnership	Hedge fund partnership	Private equity/ Venture Capital partnership	Publicly traded partnerships	Real estate partnerships
Income tax characteristics					
Passive income/(losses)	No	Sometimes	Sometimes	Yes	Yes
Preferential rate qualified dividends	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
Long-term capital gains	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
IRC Section 475 mark to market income	No	Sometimes	No	No	No
IRC Section 1256 foreign currency contracts	No	Sometimes	No	No	No
Income subject to 3.8% NIIT tax	Yes	Yes	Yes	Yes	Yes
Fund expenses subject to 2% limitation	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
Fund expenses non-subject to 2% limitation	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
Carried interest	Sometimes	Sometimes	Sometimes	Sometimes	Sometimes
Other considerations					
Frequency of liquidity	Monthly/quarterly	Monthly/quarterly	No liquidity	Daily	No liquidity
Typical fund life	Indefinite	Indefinite	7-13 years	Indefinite	7-13 years
Foreign versus domestic	Generally domestic	Domestic & foreign	Domestic & foreign	Domestic	Domestic & foreign
Typical entity type	Partnership	Partnership	Partnership	Partnership	Partnership
Frequency of asset valuation	Monthly/quarterly	Monthly/quarterly	No liquidity	Daily	No liquidity

Tax implications of fund investing

Investment fund attributes

Trader versus investor status

Typically, funds like MSFs and HFs will either be determined to be a trader (in the business of trading securities) or an investor (not in the trade or business of trading securities). This annual determination is based on the facts and circumstances of the fund surrounding frequency of trading, holding period, etc. There is no statutory definition of a trader vs. an investor, and the fund must complete an annual analysis to determine whether it is a trader or an investor for the current year. Typically, a trader is a taxpayer who buys and sells securities with reasonable frequency in an effort to catch swings in the market and profit thereby on a short-term basis. A trader can be engaged in a trade or business if the activity is conducted with continuity and regularity and with a primary purpose of producing economic income or profit. A fund that is classified as an investor typically has less trading activity and seeks to profit from more long-term investments.

If the fund qualifies as a trader, then its activities will be considered in the connection of a trade or business. Expenses such as management fees or fund expenses will be classified as trade or business expenses, fully available to offset an investor's ordinary income from the trader, as well as other sources. Conversely, if the fund is considered to be an investor, any management fees or fund expenses will not be considered in connection with a trade or business and may be limited by the itemized deduction phase-out provisions or added back under the AMT regime.

Typically, most private equity/real estate investment funds are invested in other operating business, such that the fund itself is determined not to be in the trade or business of purchasing other private equity or real estate investment funds. Consequently, most management fees or fund expenses incurred are not in connection with a traditional trade or business and may be subject to the itemized deduction phase-out provisions or added back under the AMT regime, unless the operating businesses are pass throughs and it is determined that the expenses are deductible like other expenses incurred directly in the operating businesses.

Passive activity versus non-passive activity

Ordinary income or loss generated from fund investments is typically either passive or non-passive. Passive income and losses are often generated by a rental activity or an operating business in which the taxpayer does not materially participate. Items that are non-passive income include portfolio income such as interest, dividends, and gains on stocks and bonds. Investment activity from marketable security and hedge funds is almost always not considered passive income, either because it is portfolio income or because it is trading income.

Passive losses are only deductible by an investor to the extent of an investor's overall passive income. If, in a given year, an investor has more passive losses than passive income, the excess passive losses can be carried forward indefinitely to future years. To the extent a taxpayer has carryforward losses from an investment and the investment is completely disposed of in a fully taxable transaction to an unrelated party, such losses are deductible in the year of the disposition regardless of whether the taxpayer has other passive income to offset the losses. The deductibility of carryover losses in the year of complete disposition is dependent upon how the investor has grouped its passive activities.

Investment fund attributes

If a taxpayer invests in a PEF or a REF and the taxpayer receives a current year tax estimate, consideration should be given regarding whether any loss estimates are currently deductible or whether they may be passive and the deduction is limited to the extent of projected passive income. Furthermore, to the extent you borrow to acquire an interest in a PEF or REF, you should evaluate whether the interest expense may be subject to the passive loss rules as well.

Separately-stated activities–non PTPs

Many PEFs and REFs separately state the income and losses of each of their underlying passive activities. A taxpayer may decide to separately state the passive income and losses from a passive activity as it is reported on the Schedule K-1 or group two or more activities of similar nature together. By separately stating each passive activity, the investor may deduct any current or carryforward passive losses in a year of complete disposition of that activity. If all investments from a fund are grouped together, all the investments are treated as a single passive activity, which could potentially defer the deduction of carryforward and current year passive losses until the disposition of the last investment in the fund.

By separately stating each passive activity, the investor may deduct any current or carryforward passive losses in a year of complete disposition of that activity.

Separately stated activities—PTPs

PTPs are unique because the passive activity limitations discussed above are applied separately on a PTP-by-PTP basis. Thus, a net passive loss from one PTP may not be utilized to offset passive income from another PTP or any other passive source. Rather, a passive loss from a PTP is suspended and carried forward to offset income in a future year from that same PTP. If the partner's entire interest in the PTP is completely disposed of in a fully taxable transaction to an unrelated party, any unused losses are fully deductible in the year of disposition.

Care should be given when a taxpayer invests in a FOF that then invests in PTPs. Typically, the FOF will list the activity of each underlying PTP investment separately. Upon review of the underlying Schedule K-1, it may be determined that the taxpayer indirectly invested in the same PTP through multiple investment vehicles. To the extent this occurs, the taxpayer must aggregate the income and losses allocated from the various partnership investments as it relates to that specific PTP investment. If one of the FOFs disposes of that underlying PTP investment but the other FOF does not dispose of its investment in the same PTP, the taxpayer cannot deduct the suspended passive losses from the PTP that the first FOF disposed of. Rather, the suspended losses must be aggregated with the losses related to the PTP investment that is still held and may be recognized when the other PTP FOF disposes of the underlying PTP investment.

Investment fund attributes

PTP investments are typically held through an investor's brokerage account. The monthly and year-end statements do not typically adjust the investor's tax basis for the investor's share of allocable income or loss from the PTP. Therefore, it is important for the taxpayer to track its tax basis in the PTP, so that the appropriate capital gain or loss can be calculated on disposition. It is important to note that the PTP fund will also provide details to the investor regarding the portion of the gain that will be recharacterized as ordinary in the year of disposition.

As you can see from the description above, the tax rules associated with holding PTP investments are complex and can create additional tax reporting requirements and administrative work. Therefore, when evaluating the rate of return related to PTP investments, consideration should be given to the incremental cost associated with the additional tracking and reporting requirements.

Qualified small business stock (QSBS)

Over the years, Congress has provided a variety of incentives to encourage investments in qualified small businesses. Congress believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies will encourage investments in these enterprises. In the past several years, Congress has made these incentives even more generous for QSBS acquired after September 27, 2010, to the point where a complete exemption from federal income tax on gains from the sale of certain stock is possible. VC funds often make investments in companies that may qualify as a QSBS and having a good understanding of what investments may generate QSBS gains could generate significant tax savings.

The chart below summarizes the portion of the gain from the sale of QSBS that may be excluded from income depending on when the stock was purchased. The chart also outlines the effective regular and AMT rates associated with the sale of QSBS.

Effective regular and AMT tax rates for sale of QSBS held for more than five years

Stock acquisition period	Section 1202 exclusion amount	AMT treatment	Effective regular tax rate	Effective AMT tax rate
Prior to February 18, 2009	50% of the realized gain	3.5% of the realized gain will be treated as an AMT preference item	14%	14.98%
After February 18, 2009 and on or before September 27, 2010	75% of the realized gain	5.25% of the realized gain will be treated as an AMT preference item	7%	8.47%
After September 27, 2010 and before January 1, 2015	100% of the realized gain	0.0% of the realized gain will be treated as an AMT preference item	0%	0%

Investment fund attributes

Below are some of the requirements in order for a stock to be considered QSBS.

Requirements

- The stock must be in a domestic C corporation (not an S corporation or LLC, etc.), and it must be a C corporation during substantially all the time the taxpayer holds the stock.
- The corporation may not have more than $50 million in assets as of the date the stock was issued and immediately after.
- The taxpayer's stock must be acquired at its original issue (not from a secondary market).
- During substantially all the time the taxpayer held the stock, at least 80% of the value of the corporation's assets were used in the active conduct of one or more qualified businesses.

In contrast to being able to receive a full federal income tax exemption for QSBS acquired after September 27, 2010 (but before January 1, 2015), a second alternative is available to defer gain by rolling over gains into new QSBS investments. There are also planning considerations to increase the ability to take the exclusion to the extent the amount of the excludable gain exceeds the exclusion limitation.

Unrelated business taxable income

For tax-exempt investors considering a fund investment, it is important to understand the underlying investment strategy and income that will be generated by the fund. For example, foundations generally pay excise tax equal to 1% or 2% of the net investment income earned by the foundation during the year. However, if a foundation is allocated UBTI, such income is subject to a 35% income tax rate. Accordingly, tax-exempt organizations generally try to minimize acquiring investments that generate UBTI.

Even income that is otherwise not UBTI will be UBTI if the income is from debt-financed property. As described above, many HFs utilize leverage to execute the investment strategy, thus creating UBTI for tax-exempt investors. Therefore, depending on the anticipated amount of UBTI, many tax-exempt investors will proactively choose to invest through the offshore HF blocker corporations to effectively block any UBTI from flowing through. For tax-exempt investors, it may be prudent to weigh the cost of paying tax on UBTI by holding a direct interest in a partnership HF investment (which would flow through the UBTI to the taxpayer) versus the cost of investing directly in an offshore blocker corporation, which is subject to 30% withholding on FDAP income and 35% withholding on ECI. Another activity that causes UBTI is investments in operating businesses. Typically, income from operating businesses is considered UBTI. Many PEFs and REFs generate operating income, and thus the income would be UBTI.

Ultimately, tax-exempt entities should weigh the expected appreciation and benefits of diversification that investing in underlying funds can offer against the incremental cost of paying 35% tax on UBTI.

For tax-exempt investors considering a fund investment, it is important to understand the underlying investment strategy and income that will be generated by the fund.

Investment fund attributes

State reporting

Many states with budget shortfalls recently have chosen to ramp up their tax collection efforts to help plug budget shortfalls. As a result, many states have become more aggressive and have developed enhanced systems to identify investors who have a requirement to file a tax return with the state. Therefore, when considering acquiring a fund, it is important to understand whether the fund is expected to generate state-sourced income.

Many states with budget shortfalls recently have chosen to ramp up their tax collection efforts to help plug budget shortfalls. As a result, many states have become more aggressive and have developed enhanced systems to identify investors who have a requirement to file a tax return with the state.

Funds with state-sourced income generally disclose to each investor their allocable share of state sourced income by providing state K-1s or a footnote included with the federal K-1 with state specific information. As an investor, if there is state-sourced activity, it is important to understand whether the income creates a state tax filing obligation and potential liability. To the extent there might be a state filing obligation, it is helpful to quantify what the investor's liability might be and the cost associated with any additional filings that might be necessary.

If the fund anticipates that state-sourced income will be generated, you should inquire whether the fund will withhold nonresident taxes on your behalf or whether the fund will file an entity level return, referred to as a composite tax return. In many states, the fund can file a composite tax return and pay the investors' share of tax liability attributable to the share of income allocable to the state. By participating in a state's composite filing, an investor's tax filing obligation may be satisfied. Each state has its own specific rules on which types of investors (individual, grantor trust, complex trust, partnership, and corporation) can be included in a composite return and/or have withholding performed on their behalf. Therefore, understanding what the fund plans to do to address the investor's state filing obligations will be important for investors to evaluate the cost of investing in the fund.

MSFs often qualify under special investment partnership rules providing that their investment income is not sourced to a state. Thus, to the extent the taxpayer's resident state imposes a tax, the investment income would only be subject to tax in that state. For REFs, the state-sourced income allocated to the investors is typically allocated to states where the property is located and where rental income is being received. Many PEFs also generate state-sourced income to the extent that the portfolio investments are directly in operating businesses organized as a partnership. Most resident states provide for credits for taxes paid to other states, so it is important to understand the rules of your state.

Additional state filings can be costly and increase an investor's tax exposure. Therefore, taking the time upfront to proactively analyze the incremental cost associated with additional state tax liabilities and filings will be important to quantify the potential after-tax return associated with a fund investment.

Tax implications of fund investing

Conclusion

With a solid understanding of the various types of funds and how specific attributes of the funds impact your tax position and tax compliance obligations, you can make more informed investment decisions. Considering that the ordinary tax rate is currently 39.6%, the net investment income tax rate is 3.8%, and many states/localities have income taxes, it is not uncommon for investment returns to be potentially taxed as high as 50%.

Below are some actions you may consider taking and questions you may consider asking before making an investment:

Review the investment strategy and tax consequences section of the offering documents or private placement memorandum.	**Understand the timing when periodic economic and tax information will be delivered.**	**Ask for a sample prior year Schedule K-1. If the fund is new, ask for a representative Schedule K-1 from a similar fund.**
Understand the character of the income likely to be allocated from the investment.	**Assess how the income allocated from the investment impacts your facts and tax posture.**	**If a tax-exempt investor is making the investment, what, if any, UBTI can be anticipated.**
Understand anticipated state sourced income expectations and whether the fund will file a composite return or submit withholding on your behalf if there is state sourced income.	**Inquire whether the fund is a domestic fund or foreign fund to evaluate reporting requirements.**	**Inquire about foreign filings and expected type and volume.**
For marketable security and hedge funds, understand provisions for being able to redeem capital.	**For private equity and real estate funds, understand anticipated timing of capital calls and estimated fund life.**	**For private equity and real estate funds, understand whether the activities will be separately stated on Schedule K-1.**

As taxpayers seek to diversify their portfolios, we anticipate that opportunities to invest through funds will continue to grow. Therefore, understanding the tax consequences associated with the investments will allow you to proactively plan and enhance your investments.